12.03 Interest on Notes Payable

Interest on notes payable is calculated similarly to interest on notes receivable.

- If N/P occurs in the ordinary course of business, record at **face value.** (Don't present value)
- L/T payables are recorded at **present value (PV).**
- If Long-term notes are payable in installments, the principal amounts that are due within the next 12 months or the operating cycle whichever is longer, must be reported as current liabilities, called **current portion of long-term debt.**

Note: When violation of a debt covenant gives the lender the right to call the debt, and the lender does not waive this right, this violation should typically result in the classification of the entire debt as **current** *by the borrower.*

Notes payable may be noninterest bearing, interest bearing, or bear a rate of interest that is not considered a fair rate. When this is the case, the same rules that apply to notes receivable also apply to notes payable.

- **Notes received/paid solely for cash** (assume rate is fair)

N/R	X	
Cash		X

Cash	X	
Notes payable		X

- **Notes received/paid for goods or services**
    - Note receivable at a **reasonable rate**. The PV of the note is the same as the Face amount. (face)

Notes receivable	10,000	
Asset		X
Gain		X

Asset	X	
N/P		X

- **Noninterest-bearing notes**
    - If the interest rate is not stated or is unreasonable, use the **FMV of the goods or the FMV of the note,** whichever is more easily determinable. Assume the FMV of the asset is 9,000.

Notes receivable	10,000		
Discount on N/R		1,000	**> cv = 9,000**
Equipment		6,000	
Gain on sale		3,000	

Asset	9,000		
Discount on N/P	**1,000**		
N/P		**10,000**	> cv = 9,000

- If the interest rate is not stated, the FMV of the goods or the FMV of the note is not determinable, **Impute** an interest rate. Use a reasonable rate for a note of this type. PV of a note in 2 years at 10% is .8265 × 10,000 = 8,265.

Notes receivable	10,000		
Discount on N/R		1,735	> cv = 8,265
Equipment		6,000	
Gain on sale		2,265	

Asset	8,265	
Discount on N/P	**1,735**	
Notes Payable		**10,000**

- When interest rate isn't fair, the fair rate must be **imputed.**
  - Receivable/Payable is carried at the present value of payments discounted at fair interest rate.
  - Periodic interest income/expense accrues based on fair rate.

In some cases, an entity may generate cash by issuing a note payable and discounting it with another entity or a financial institution. An entity, for example, may issue a noninterest-bearing note that matures in one year, discounted at a bank at a rate of 8%.

- The maturity value will be equal to the face value since it is a noninterest-bearing note.
- A discount will be computed by multiplying the maturity value (face value in the case of noninterest-bearing notes) by the discount rate.
- The result, adjusted for the length of time from the date of discounting to maturity, will be recorded as a discount.

The entry will be:

Cash (for net proceeds)	X	
Discount on note payable (maturity amt × discount rate × time)	X	
Note payable (face amount)		X

The discount is then amortized according to the entity's policies. The effective interest method is generally preferred but straight-line is also used.

Refinancing of Short-Term Obligations on a Long-Term Basis

Obligations maturing within one year or the operating cycle, whichever is longer are considered short term. If the company **intends** to refinance the obligation on a long-term basis, it is classified as long term.

- Intent & Ability:
  - Actually **issuing long-term debt** or Equity securities after the balance sheet date, but prior to the issuance of the financial statements.
  - Signing a **firm agreement** to refinance the obligation with a lender or investor that has the financial ability to provide the financing.

Special Loss Contingencies

- **Unconditional Purchase Obligation (Purchase Committments)**
  - If obligated to purchase goods for a period of time at a fixed price, the liability is disclosed for each of the 5 years following the Balance Sheet date.
    - Accrue loss if the market value of the item falls below the purchase price. The loss will be for the Minimum quantity required to be purchased.

Assume the client signed a 3-year contract at 1/1/X1 agreeing to purchase 1,000 units per year of particular goods at 10 cents per unit. At 12/31/X1, the notes must disclose the fixed obligations for the remaining contract:

- 20X2 100
- 20X3 100

Assume, however, that the goods in question become obsolete during 20X1, and at the time the financial statements for 20X1 are being issued, the client estimates that the best alternative available will be to sell the goods for scrap for 2 cents per unit.

In addition to writing down any inventory on hand at 12/31/X1 to market, the client must accrue a liability for the 8-cent loss expected on the unconditional obligation to purchase 2,000 additional units over the next two years:

Estimated loss on purchase commitment	160	
Estimated liability on purchase commitment		160